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States Should Conform to GILTI, Part 3: Elevator Pitch and Q & A

David Gamage

Darien Shanske

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Darien Shanske is a professor at the University of California, Davis, School of Law (King Hall), and David Gamage is a professor of law at Indiana University Maurer School of Law.

In this installment of Academic Perspectives on SALT, the authors counter common arguments against state conformity to GILTI, arguing that the policy has thus far been rejected not on the merits, but rather thanks to brute-force corporate lobbying that has been rationalized as a triumph of reason.

Introduction

The 2017 federal tax overhaul slashed the corporate income tax rate,[1] but also enacted new antiabuse provisions targeted at corporate tax planning that shifts reported profits to foreign tax havens or other foreign low-tax jurisdictions. The most important of these antiabuse rules is the global intangible low-taxed income regime.

States have also seen their corporate income tax bases eroded by corporate tax planning that shifts reported profits to foreign tax havens or other foreign low-tax jurisdictions. This tax planning has deprived states of needed revenue, while making their tax systems less fair and less efficient because of the economic waste and inequities resulting from some corporate taxpayers aggressively engaging in these forms of tax planning.

GILTI now offers states a tool to combat this harmful tax planning. As we have argued previously, states can and should make use of this tool by conforming to GILTI.[2]

The essence of our argument can be summarized in three sentences. First, states should conform to GILTI because there is significant evidence that profit shifting is substantially eroding their corporate tax bases. Second, GILTI is a tool for identifying shifted profits. Third, there are many legally and analytically sound ways to apportion GILTI income to a state.

The remainder of this essay elaborates on and supports each of these sentences. But as a precursor, it may be helpful to provide background to set the stage for our analysis.

Regrettably, most states are not conforming to GILTI. Even more regrettably, this fact is now being cited as another reason that states should not conform to GILTI.

It is of course understandable for taxpayers to lobby politicians not to tax them, and we suppose somewhat natural — if still fallacious — for a victory of brute force to be rationalized as a triumph of reason. Yet the arguments for conforming to GILTI have no more been defeated

[1] For broader discussion and critique of related aspects of the 2017 federal tax legislation, see David Kamin et al., "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation," 103 *Minn. L. Rev.* 1439, 1488-1514 (2019).

[2] Darien Shanske and David Gamage, "Why States Can Tax the GILTI," *State Tax Notes*, Mar. 18, 2019, p. 967; and Shanske and Gamage, "Why States Should Tax the GILTI," *State Tax Notes*, Mar. 4, 2019, p. 751.

in the arena of ideas than was mandatory worldwide combination, an even better tax policy that was also defeated by interest-group politics rather than by policy arguments.[3] Cynically, the end of worldwide combination is now also suggested to have been a matter of policy, contrary to any plausible claim of fact.

What to do? We have already argued for GILTI conformity at length.[4] We will try again in this essay by framing the argument a little differently, with specific and short takeaways.

Our Elevator Pitch in 3 Sentences (With Commentary)

There is debate as to the scale of corporate profit shifting. The global consensus is that it is a problem.[5] This consensus can be disputed by opponents of state conformity to GILTI, but it would be wise for states to follow the lead of the OECD, the United Kingdom, and the Republican Congress that passed GILTI (and the base erosion and antiabuse tax) in believing that corporate profit shifting is a problem that governments should take steps to counter.

Thus, the first sentence of our elevator pitch is: **States should conform to GILTI because there is significant evidence that profit shifting is substantially eroding their corporate tax bases.**

Further, though GILTI does operate as a global minimal tax, it is simultaneously an attempt to identify shifted income. Both objectives can be and are true. GILTI identifies suspiciously high returns, but also grants a foreign tax credit to establish a minimum tax. Conceptually, a state can opt to use GILTI as a mechanism for identifying shifted profits without also using it to establish a minimum tax. And why should states seek to make sure that a large multinational corporation pays at least a minimum amount to foreign jurisdictions?

Thus, the second sentence of our elevator pitch is: **GILTI is a tool for identifying shifted profits.**

And so a state should conform to GILTI insofar as it identifies likely displaced income. The next question is how a state should do so. First, a state needs a theory as to how much GILTI has a U.S. source. Two prominent tax economists who proposed a proto-version of GILTI in 2013 argued for 50 percent because there is evidence that this is a rough estimate of the U.S. contribution to global research and development.[6] Conforming to the 50 percent deduction of IRC section 250 is thus an easy way of building in this reasonable analysis.

But then what to do about the 50 percent apportioned to the United States? We think just using the state's ordinary apportionment formula is reasonable. We think numerous alternative options are also reasonable, such as the use of GDP.[7]

Thus, the third sentence of our elevator pitch is: **There are many legally and analytically sound ways to apportion GILTI income to a state.**

These three sentences are all that is essential, but we will nevertheless follow up with some anticipatory housekeeping.

Call and Response

Objection 1: But GILTI is foreign income.

There are multiple errors embedded in this claim. First, states can tax foreign income; that they do not is a matter of historical practice. Second, when a state apportions GILTI to itself, it

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[3] For the argument as to why now is a particularly good time to return to mandatory worldwide combination, see Shanske, "White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting," *State Tax Notes*, Sept. 17, 2018, p. 1181.

[4] *See* Shanske and Gamage, both articles, *supra* note 2.

[5] Jane G. Gravelle, "Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?" Apr. 26, 2016. ("While the magnitude of corporate profit shifting by U.S. multinationals into low or no tax countries is uncertain, there is overwhelming evidence of its existence and its increase in recent years.").

[6] Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," 66(3) *Nat'l Tax J.* 671, 681 (Sept. 2013).

[7] The use of GDP is a reasonable choice made by New Jersey that has been subjected to quite unreasonable criticism. We hope some other state uses it again. GDP makes sense as a guess for where sales are happening and income is being generated. While imperfect, it is at least as good — arguably better — than using population. Population is commonly used as a secondary rule of reasonable approximation in the Multistate Tax Commission's model allocation and apportionment regs in connection with intangibles and services. *See* MTC, "Model General Allocation & Apportionment Regulations With Amendments Submitted for Adoption by the Commission" (Feb. 24, 2017). We might have missed it, of course, but neither of us recalls such hyperbolic gnashing of teeth in that context, which is essentially the same. GILTI is displaced income and so we are using a sensible default option, just as one does when there is a difficulty locating the ultimate destination of intangibles or services.

is *not* taxing foreign income, but rather is using reasonable formulas to tax domestic income.[8]

Response 1: Including apportioned GILTI income is taxing domestic — not foreign — sourced income.

Objection 2: But GILTI income is, by definition, the income of a controlled *foreign* corporation.

This is the same objection, just made more loudly and slowly. The objection is technically true, but irrelevant, as the U.S. Supreme Court has held many times,[9] including twice in this context,[10] that states do not need to divide up income in the manner that a taxpayer does so.

Response 2: A state does not need to take a taxpayer's word on where income is earned and, in light of the evidence of massive profit shifting, states should not just take a taxpayer's word on where income is earned. Instead, a state can and should use its own reasonable method to determine where income is actually earned.

Objection 3: But GILTI is a minimum tax and so, by implication, is not a tool to identify income shifting.

It is within a state's discretion to adopt one aspect of GILTI but not another. The Supreme Court has made it clear, including in decisions like *Kraft v. Iowa*,[11] that the IRC does not preempt state revenue design choices. Even more aptly, the Court reached this conclusion specifically as to nominally foreign income in *Container* and *Barclays*.[12]

Response 3: States are permitted to conform to part of GILTI to accomplish one of GILTI's policy goals without conforming to all of GILTI.

Objection 4: GILTI is imperfect, with the implication being that states should not conform to it because it would be so unfair or even constitutionally problematic.

As a legal challenge, this flies against what we all learn in Con Law I — that taxation decisions are subject to rational basis review. If deeply imperfect tax laws like California's Proposition 13 count as rational, then conforming to GILTI easily passes the test to count as rational.[13]

As a policy matter, it is possible that an innocent firm (that is, a firm not involved in profit shifting) might face an additional tax burden as a result of GILTI. Almost all elements of tax law are imperfect, after all, and every major antiabuse rule that we know of can be criticized as catching some arguably innocent taxpayers in its net. But to refrain from enacting antiabuse rules on this ground would lead to tax systems falling apart in the face of aggressive tax planning.

In any case, we doubt that many firms not involved in profit shifting will face substantial additional tax burdens as a result of GILTI. Moreover, states have at least three tools to address this to the extent it does occur. First, taxpayers can petition for alternative apportionment. Second, if there is a recurring problematic pattern, say for very profitable service firms with few assets, then state regulators could issue regulations as they have in other special contexts. Third, taxpayers can opt for worldwide combination, which takes into account all of a unitary business's income and factors.

Response 4: As a matter of law, GILTI is more than reasonable enough. As a matter of policy, states have the tools to mitigate significant unfairness in the unlikely event that it arises.

Objection 5: You just mentioned worldwide combination. Worldwide combination is the worst and GILTI is just a poor form of worldwide combination.

Mandatory worldwide combination would actually be superior to conforming to GILTI.[14] States only moved away from this approach under political pressure, which would be unlikely

[8] And so this disposes of objections based on *Kraft v. Iowa*, a case involving income that was stipulated to be foreign. *Kraft General Foods Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71, 77 (1992). ("The only subsidiary dividend payments taxed by Iowa are those reflecting the foreign business activity of foreign subsidiaries.").

[9] *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980); *Butler Brothers v. McColgan*, 315 U.S. 501 (1942).

[10] *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 321-31 (1994); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 196 (1983).

[11] *Kraft*, 505 U.S. at 82. *See also* Shanske, "States Can and Should Respond Strategically to Federal Tax Law" (June 10, 2019), *Ohio North U. L. Rev.* (forthcoming).

[12] *Container*, 463 U.S. 159; *Barclays Bank*, 512 U.S. 298.

[13] *Nordlinger v. Hahn*, 505 U.S. 1 (1992).

[14] *See* Shanske, *supra* note 3.

today when the entire OECD is working on profit-shifting issues. One way you know that worldwide combination is a sound policy is by the incoherence of objections to it. For instance, some contend that various kinds of GILTI conformity would be terribly unfair to some taxpayers because they do not allow the inclusion of sufficient foreign factors, but not so unfair that these taxpayers would actually make a worldwide election that would permit inclusion of all foreign factors (but also require inclusion of all income). This illustrates that the argument for greater inclusion of foreign factors in GILTI is strategic. Partial inclusion is more easily subject to manipulation and thus likely to reduce tax liability; full inclusion is harder to manipulate and so disfavored.

Response 5: Yes, we should go back to worldwide combination, but conforming to GILTI is a sound first step.

Objection 6: This is just an ad hoc money grab.

Are you familiar with Texas's margin tax? It is hard to raise enough revenue to provide services that constituents want. Sometimes this results in odd taxes. Indeed, it almost always does, as the deviations from principle in all taxes are legion. In any event, it just so happens that combining a profit split (done by GILTI) with apportionment of supranormal profits by formula based on consumption (how a state would likely conform) is the cutting edge of corporate tax theory at the moment.[15] This is not the place to argue for this vision, just to note that in fact GILTI conformity is not ad hoc, even if that were a meaningful objection.

Response 6: Pairing GILTI with single-sales-factor apportionment approximates the cutting edge in thinking about corporate taxation.

Objection 7: You don't even need the money!

It is true that times are relatively good for many states right now. But state revenue systems are volatile and produce a lot less revenue just when they have more needs.[16] GILTI income is likely to be pro-cyclical and states should use it accordingly by allocating a generous portion to reserve funds or one-time projects.

Response 7: Winter is coming!

Objection/Threat 8: We will move if you conform!

A taxpayer that moves because of GILTI will not reduce its corporate tax liability, including for GILTI, owed to the state it moves from if that state uses single-sales-factor apportionment. This is because the taxpayer's customers will not move. To be sure, a taxpayer that moved from a state would now pay less of *other* state and local taxes to that state, but that is already the case. Conforming to GILTI does not change the cost-benefit analysis.

Response 8: It would be irrational for a taxpayer to move because of GILTI conformity because GILTI conformity does not increase a taxpayer's tax liability based on its physical presence in the state.

Conclusion

To return to the beginning, of course taxpayers likely to pay more in taxes under GILTI conformity are lobbying state legislators not to do so. Yet the policy case for GILTI conformity is very strong, and the arguments against it are rather weak or inaccurate. In this essay, we are trying to clarify matters. If you are — or work for — a state legislator considering conforming to GILTI, and if you still have questions or concerns, please give us a call. ■

[15] Michael P. Devereux et al., "Residual Profit Allocation by Income," Oxford University Centre for Business Taxation Working Paper WP19/01 (Mar. 22, 2019); Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9(5) *Fla. Tax Rev.* 497-553 (2009).

[16] Gamage, "Preventing State Budget Crises: Managing the Fiscal Volatility Problem," 98 *Cal. L. Rev.* 749 (2010).